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A Study of the Effects of Financial Reporting Transparency on the Quality of Earnings in Companies Listed in Tehran Stock Exchange

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ABSTRACT: Providing useful information concerning company's profitability is an objective of accounting and financial reporting on the subject of earning. Accordingly, accounting earning as an effective tool for users' decision making has special importance and it is a desirable and significant indicator for users and investors. In the past two decades, "earning quality" subject has been particularly interested by experts and they seek to attain a logical and authentic methodology to evaluate earning quality and to identify affective factors in it. Therefore, in the present research, the degree of the influence of transparency in financial reporting in earning quality is evaluated. This research objective is to study the relationship between transparency in financial reporting and earning quality. Three hypotheses which are analyzed through correlation coefficient test, t-statistic and regression analysis are proposed to achieve the research objectives. The following overall conclusion was obtained: the comparison between the obtained results from forward method and the situation in which only the variable of management (domain) transparency rank with earning quality were evaluated, show completely similar results as the determination coefficient in both models are 0.044. The obtained results indicates that the entrance of control variables do not influence the main model and cannot affect earning quality. So, management (domain) transparency rank will be enough for earning quality measurement. Also, it must be noticed that the determination coefficient of this variable is not significant and to increase earning quality forecast, other variables must be measured.

Keywords: Transparency in financial performance, Earning Quality, Transparency in financial reporting

ORIGINAL ARTICLE

INTRODUCTION

Financial analysts, in their assessment, must notice not only the quantity of earnings but also the quality of earnings. The quality of earnings is referred to the potential background of earnings growth and the likelihood of future earnings realization. In other words, the value of a single share not only is dependent on the company's earnings per share of the current year, but also is dependent on the expectations of the company's future, the profitability strength of future (following) years and the reliability coefficient related to the future earnings.

Earnings quality is a critical Measurement for the financial health of the business unit (company). Earnings quality is a multidimensional concept. Although it has different aspects, it does not have a singular meaning. That's why; different definitions as well as different measures have been proposed with regard to earnings quality. However, due to the complex nature of the subject, giving a clear definition for the quality of earnings is difficult. The quality of earnings is referred to the potential background of earnings growth and likelihood of future earnings fulfillment (Ismaili, 1386).

In the absence of full transparency in financial reporting, managers have the opportunity of hiding negative information inside the company, in order to keep their professional career and credit. Therefore, the negative information is accumulated inside the company. When the mass of the accumulated negative information reaches its peak, storing it for a longer period of time becomes impossible and expensive. As a result, the mass of negative information enters to the market all at once, and leads to the fall in stock prices.

Therefore, to achieve the above objectives, accounting and financial reporting must provide good information about earnings components and ultimately the quality of earnings to the users. So, doing beneficial researches and investigations is one of the efficient tools that can worthily contribute to social and economic development. Consequently, the results of this research can be responsive to the needs of many users.

A Review on Research Literature

According to the conducted research, there is no study being almost identical to the present study, in our country. Emphasizing on the role of accrual accounting, Khajavi etal. (2005) examined the relationship between earnings quality and stock returns. Based on the research findings, average stock returns of companies are not affected by the impact of accrual accounting and its related components. Noravesh et al. (2005) in a research studied the relationship between earnings quality and cost of capital in companies listed in Tehran Stock Exchange (TSE). The results showed that in the test era (1993-2003) except for the year 2000, there is an inverse relationship between earnings quality and the cost of capital. The findings of Penman et al. (2002) show that conservative accounting, will lead to earnings quality. Schipper et al. (2003) in their study, examined the measures evaluating of earnings quality, and the results showed that the quality of earnings in addition to common standards, is also dependent on the type and amount of contracts based on accounting data.

Aksu (2006), studied the effects of disclosure transparency in Istanbul Stock Exchange based on the *Standard* and Poor's definition of transparency, which includes timely and adequate disclosure of financial and operating performance. He believes that transparency and proper disclosure protect the rights of investors, shareholders and other stockholders (beneficiaries) who do not have access to first-hand information. It is expected that increased information transparency minimizes information asymmetry and the risk of fraud, as well as it reduces the cost of capital and increases firm value. Aksu showed that transparency and proper disclosure causes the reduction of political spending and unacceptable tax costs.

Hunton, et al. (2006) in a study that included 62 professional financial manager and the board members, reviewed the effect of financial reporting transparency on current earnings increase and on the reduction of earnings management efforts. They found out that the financial reporting transparency significantly makes adjustments in earnings management, rather than complete elimination. Their findings agree with the managers believes, based upon the fact that when disclosure trends are accomplished with less transparency, earnings management can lead to share price improvement, reliability of financial reporting faces no mark of alteration. But when the financial statements have more transparency, earnings management harms the accuracy, correctness and reliability of financial reporting.

Sloan (1995) showed that firms with higher reported earnings than operating cash flow (high volume of accruals), will experience a decline in operating earnings in the coming years. Thus the accruals volume is a good indicator for earnings quality. Nordin et al. (2009) examined the effect of family ownership structure and board of director’s composition on the transparency of financial reporting. From their viewpoint, transparency of financial reporting includes some dimensions such as: quality of earnings according to accruals quality, usefulness of earnings, and the accuracy as well as the amount of earnings management. They studied the correlation of family firm’s ownership and the composition of board members, with the transparency of financial reporting. Their findings show that the independence against the dependent of the Board of Directors members affects the improvements of company transparency. Moreover, the independence degree of Board of Directors members positively and significantly associated with the transparency of financial information reporting.

Wang et al. (2007l) examined the relationship between the timeliness of disclosure and transparency of reported financial information in China Exchange. Examining 2894 observations during the financial period of 2004-2006, they found that after controlling common factors such as the auditor’s opinion, the timeliness of annual financial reports is positively related to information transparency. The firms which emit timing of financial information especially prospective financial information will experience high levels of information transparency and low earnings management.

Pizarro et al. (2007) studied the effect of institutional ownership and transparency on listed companies In Chile Exchange. They found that institutional ownership negatively influences the transparency of financial reporting of the company. They provided an index to measure the transparency which is calculated and scored by the use of the governance mechanisms. Through the application of 700 year - firm during the period of 1995-2005, in addition to the above results, they found that there is a positive and significant relationship between the use of international financial reporting standards and the firm’s transparency of reporting.

Research Hypothesis

1. There is a relationship between transparency rank of the company in financial performance dimension and quality of reported earnings.
2. There is a relationship between transparency rank of the company in board and management dimension and quality of reported earnings.
3. There is a relationship between transparency rank of the company in ownership structures dimension and quality of reported earnings.

MATERIALS AND METHODS

The statistical population, sample and sampling method

The statistical population of this research is the study of a period of 5 years from 1386 until 1390. Tehran Stock Exchange is the place of research and the research subject is "the impact of the transparency of financial reporting on earnings quality". The statistical population consists of all companies listed on the Tehran Stock Exchange.

The statistical sample in this research is selected using systematic removal and must have the following conditions:

1. The companies which are not investment companies, insurance companies or banks.
2. The companies whose data is available in the time period.
3. The companies which ended their fiscal year at the end of March.

Applying the above conditions, 130 companies were selected to estimate the models and test the hypotheses of the research.

Variables of the research

The necessitated data is provided through the application of Tehran Stock Exchange Information Center, from the financial statements of listed companies in Tehran Stock Exchange. In the present study, first the original data, from PDF files, are conveyed into Microsoft Excel. Then, the necessitated data is provided through Microsoft Excel for placement in the model. In order to analyzing data and testing hypothesis, statistical software SPSS, EXCEL is used.

Dependent variable

Earnings quality: is a multidimensional concept that is based on content and therefore it has no single definition. Elements of earnings quality can be classified into two groups: qualitative group and quantitative group. Qualitative group is referred to the elements that in the extant accounting system are not able to be measured and quantified, but quantitative group is referred to the elements that have the ability and power of being quantified and they can be recorded in the accounting system. The quality of earnings is referred to the potential background of earnings growth and the likelihood of future earnings fulfillment. The method of the dependent variable measurement is as follows:

Information related to the operating earnings of the current year for 5 years of the companies is achieved and earnings quality is obtained through the application of y = a + bx equation of Dchv and Dychv model.

Y = a + bx

Y= Operating earnings of the current year

a= constant factor

b= Earnings Quality

x= Operating earnings of the previous year

Independent variable

In this study independent variables are measured by Standard and Pools. In this standard, variables are divided into three categories, including: the transparency of the ownership structure, financial transparency, and board of directors' structure.

1. The ownership structure and owners' rights (28 measures)
2. Financial transparency and information disclosure (35 measures)
3. The board of directors and management structure (35 measures)

If any of the above information is reported to the company, a score of 1is given, otherwise a score of 0 is given. It is calculated for each company by the following equation:

$TDS = \Sigma\ \Sigma S_{jk} / TOTS$

TDS: The final rankings of transparency and disclosure,

J: Measurement dimension of transparency,

K: number of criteria

TOTS: maximum point which can be allocated,

S_{jk}: allocated score to each criterion.

RESULTS

Descriptive Statistics

Descriptive characteristics are examined as the table 1:

Descriptive results of the research variables show that the mean of dependent variables, that's to say the quality of company earnings is 359/0 and standard deviations of it is 550/0. Also, the independent variables mean of companies transparency rank in ownership structure dimension, companies transparency rank in management and board of directors dimension, and companies transparency rank in financial performance dimension are respectively 319/0, 182/0 and 505/0.

Analytical Statistics

The examination of the results of the statistical summary table 2 shows that multiple correlation of companies' earnings quality with the linear combination of dependent variable of transparency rank of the company in ownership structures dimension, transparency rank of the company in board of directors and management dimension, and transparency rank of the company in financial performance dimension is equal to R=0.253 and determination coefficient value is equal to R^2=0.064. That's to say, the proportion of the dependent variable variance which is explained by the relative contributions of the independent variables are equal to 0.064. In other words, the independent variables generally could justify only 6.4 percent of total companies' earnings quality changes. The remaining changes are related to other factors and random events that are outside the model. The estimation standard error measures and shows the amount of the dispersion of points around the regression line in two-dimensional space. The larger the index value, the greater the dispersion of points around the regression line, and it represents the prediction power of regression equation which is obtained 0.538 in this hypothesis. Durbin-Watson statistic is 1.702 which is a suitable number (number between 5.1 and 5.2 is acceptable). Therefore, Data has an appropriate independence.

Table 1. Descriptive statistics of study variables

		Earning quality	Structure	Managers	Performance
N	Valid	124	124	124	124
	Missing	0	0	0	0
Mean		0.3598	0.319	0.182	0.505
Std. Deviation		0.55024	0.03815	0.04839	0.05108
Variance		0.303	0.001	0.002	0.003
Skewness		0.171	-2.240	0.285	0.441
Std. Error of Skewness		0.217	0.217	0.217	0.217
Kurtosis		0.058	3.068	-1.837	-1.388
Std. Error of Kurtosis		0.431	0.431	0.431	0.431
Range		2.84	0.11	0.10	0.13
Minimum		-1.01	0.22	0.14	0.45
Maximum		1.83	0.33	0.24	0.58
Percentiles	25	-0.0185	0.3333	0.1379	0.4516
	50	.3760	0.3333	0.1379	0.4839
	75	0.7088	0.3333	0.2414	0.5484

Table 2. Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	0.253[a]	0.064	0.041	0.53894	1.702
a. Predictors: (Constant), X3. Performance, X1. Structure, X2. Managers					
b. Dependent Variable: Earning quality					

DISCUSSION

The results of the examination of the first hypothesis, based upon the existence of a relationship between the transparency rank of the company in financial performance dimension and the reported earnings quality, shows no meaningful relationship between the transparency rank of the company in financial performance dimension and the reported earnings quality. But can lead to change dependent variable, to some extent; so that transparency rank of financial performance variable with beta coefficient of 0.097 will increase the company's quality of earnings.

The results of the examination of the second hypothesis, based upon the existence of a relationship between the transparency rank of the company in board of directors and management dimension and the reported earnings quality, shows a significant relationship between the transparency rank of the company in board of directors and management dimension and the reported earnings quality. Determination coefficient of the transparency rank of the company in board of directors and management dimension itself is equal to 0.044. So we can conclude that the most important factor in earnings quality prediction is the transparency of the board of directors and management dimension. Additionally, the results of the examination of the hypothesis regarding to the transparency in board of directors and management dimension confirm to the results of the examination of Nordin et al. (2009) and Pizarro et al. (2007) which showed that management independence positively influences the degree of transparency and consequently on earnings quality.

The results of the examination of the third hypothesis, based upon the existence of a relationship between the transparency rank of the company in ownership structures dimension and the reported earnings quality, shows no meaningful relationship between the transparency rank of the company in ownership structures dimension and the reported earnings quality. The transparency rank of the ownership structures with determination coefficient of 0/026 has the lowest impact on the companies' earnings quality.

Research Proposals

A) Proposals based upon the research results

• Diversification of business and financial activities of the company potentially lead to expect a considerably different "quality" among firms. Perhaps it's because of unfamiliarity of the public markets with accounting standards usage in assessing the quality of earnings. It is therefore suggested that market practitioners become more familiar with the concepts and application of accounting standards.

• It is recommended that investors and creditors before making any decisions assess the earnings quality and the degree of disclosure in the board of directors.

B) Suggestions for future research

• The relationship between the level of voluntary disclosure of companies and earnings quality.

•Subsequent researchers make use of other variables to examine the quality of earnings.

6. Conclusion

The comparison between the obtained results from forward method and the case in which only the variable of transparency rank of management dimension with earnings quality were measured, shows that the results of both tests are similar. The determination coefficient of both tests is 0/044. These results suggest that the entry of the control variables does not affect the original model and cannot affect the quality of earnings. Therefore, to measure earnings quality, we can only be satisfied with the transparency rank of management dimension. But it should also be noted that the determination coefficient of this variable is not significant and to increase the quality of earnings forecasts other variables must be considered.

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